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Double Benefits and Transactional Consistency Under the Tax Benefit Rule

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—"A foolish consistency is the hobgoblin of little minds, adored by little statesmen and philosophers and divines." [1]

Introduction

Over the years, the Commissioner and the courts have developed several rules to deny taxpayers so-called "double benefits." It is our thesis that although these rules have a salutary effect when properly applied, the fear of allowing double benefits to taxpayers has occasionally misled the Commissioner and the courts into improper, or at least unanalyzed, disregard of other tax policies which are specifically expressed by Congress or which have been themselves developed by administrative-judicial interplay.

Part I

The Rules and Their Proper Application

A tax benefit may be provided to taxpayers by either an exclusion from gross income or a deduction. The word "deduction" is here used to include not only current outlays normally considered deductions, but also any reduction of gain (or increase of loss) due to past outlay, for example, depreciation or basis offset in determining gain or loss on sales under section 1001. There are four possible double combinations of exclusion and deduction; thus the rules designed to prevent double benefits have naturally arisen in four general types of situations.

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[1] R.W. EMERSON, *Self-Reliance*, ESSAYS, FIRST SERIES 58 (1884).

Rule Against Deduction-Deduction

First, the regulations state in several places that "double deductions are not permitted."[2] Some examples come readily to mind. If *T* has deducted a repair cost under section 162, the expenditure cannot again be deducted as a loss under section 165 or as depreciation under section 167 or 168.[3] If *T*, an accrual basis taxpayer, has deducted accrued interest, the payment of the interest cannot also be deducted.

In other instances, the application of the rule is less obvious, although nonetheless proper. Suppose in year 1 *T* has $20,000 of gross income from oil operations, and for that year properly deducts $5,500 (27.5%) as percentage depletion. Suppose further *T* is required to refund $10,000 to its customers in year 2 because its year 1 receipts could not legally exceed $10,000. If *T* could not have taken any cost depletion in year 1 because its basis in the oil well had been reduced to zero by previous depletion allowances,[4] *T* should be allowed a deduction of only $7,250 ($10,000 — $2,750) for the refund made in year 2. If *T* were allowed a $10,000 deduction in year 2, $2,750 of the refund would be deducted twice, once as percentage depletion in year 1 and again as a loss in year 2. The Supreme Court so held in *United States v. Skelly Oil Co.*[5]

Rule Against Deduction-Exclusion

Second, there is the tax benefit rule, which, in its narrowest formulation, prevents exclusion of a recovery of a prior expenditure if the expenditure was deducted with tax benefit. It is probably the most well known of the four rules. One of the clearest examples of its application is *Alice Phelan Sullivan Corp. v. United States.*[6] The taxpayer gave property to a charity subject to a condition, but received the property back again in a later year because the charity no longer complied with the condition. Because a charitable deduction had been taken for the gift, the court required the taxpayer to include in its income for the year of the recovery an amount equal to the previous deduction. Other familiar examples are refunds of state income taxes previously taken as itemized deductions under section 164, and the payments received on debts previously deducted as bad debts under section 166.[7]

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[2] *See, e.g.*, Reg. §§ 1.161–1(a), 1.212–1(o), 1.1016–6(a) ("adjustments must always be made to eliminate double deductions or their equivalent").

[3] National Bronx Bank v. Commissioner, 3 T.C.M. (CCH) 60 (1944).

[4] Revenue Ruling 75–451, 1975–2 C.B. 330, provides that depletion cannot reduce basis below zero.

[5] 394 U.S. 678 (1969). This case is discussed further in Part II of this article.

[6] 381 F.2d 399 (Cl. Ct. 1967).

[7] The tax benefit rule has a corollary that no inclusion is required where the previous deduction did not benefit the taxpayer. *See* I.R.C. § 111.

The tax benefit rule also has less obvious, but nonetheless proper, applications. In one of the two companion cases decided by the Supreme Court in *Hillsboro National Bank v. Commissioner,*[8] a corporation deducted an amount which it had paid for feed grain in its dairy operations. In a subsequent year, before it had used the feed grain in its business, the corporation distributed the grain to its shareholders in complete liquidation. The Court held that the tax benefit rule required an inclusion in the corporation's gross income for the year of the liquidation equal to the amount of the earlier deduction. The Court reformulated the rule as follows:

> The purpose of the rule is not simply to tax "recoveries." On the contrary, it is to approximate the results produced by a tax system based on transactional rather than annual accounting. . . . [T]he tax benefit rule will "cancel out" an earlier deduction . . . when a . . . later event is fundamentally inconsistent with the premise on which the deduction was initially based.[9]

Rule Against Exclusion-Deduction

There is, third, a rule which prevents the deduction of an amount previously excluded. An example of this rule is found in *Detroit Edison Co. v. Commissioner.*[10] The taxpayer, a utility company, received payments from its customers for the construction of service facilities. The company did not include these payments in income, but took depreciation deductions on the facilities in a later year. The Supreme Court upheld the denial of the deductions, stating:

> [The receipts] have not been taxed as income, presumably because it has been thought to be precluded by this Court's decisions in *Edward v. Cuba R. Co.*, 268 U.S. 628, holding that under the circumstances of that case a government subsidy to induce railroad construction was not income. But it does not follow that the Company must be permitted to recoup through untaxed depreciation accruals on investment it had refused to make.[11]

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[8] 103 S. Ct. 1134 (1983).

[9] *Id.* at 1142–43.

[10] 319 U.S. 98 (1943).

[11] *Id.* at 103. Under § 113(a)(8) of the 1939 Code, the taxpayer would have taken a carryover basis if the payments were considered a "contribution to capital." The Court refused to consider them as such. *But see* Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950). The stakes in controversy over when a payment by a nonshareholder is a contribution to capital by a nonshareholder are lessened under the 1954 Code by § 362(c) which, consistently with *Detroit Edison,* gives a corporation a zero basis in property it receives as a contribution to capital from a nonshareholder. *See generally* United States v. Chicago, B. & Q. R.R., 412 U.S. 401 (1973).

Hintz v. Commissioner, 712 F.2d 281 (7th Cir. 1983), raised the exclusion-deduction problem in another context. The taxpayer received sick pay and unemployment benefits, but was required to repay them in a subsequent year. The

Rule Against Exclusion-Exclusion

Fourth is the rule that prevents a second exclusion of an amount previously excluded. The clearest application of this rule is *United States v. Kirby Lumber Co.*,[12] where the Court established the principle that a discharge of indebtedness is gross income. Borrowed money is initially excluded from the borrower's gross income because it is presumed that the debt will be repaid. If the debt is instead discharged at arm's length without payment, the gain on the discharge cannot also be excluded, but is gross income.

Another, perhaps less obvious, application of this rule is the holding of *Crane v. Commissioner*[13] (as clarified by *Commissioner v. Tufts*[14]) that the face amount of a mortgage note must be included in the amount realized on disposition of the encumbered property, even if the note is a nonrecourse obligation and even if the fair market value of the property is less than the amount of the note. Because the amount borrowed is excluded at the outset, it must be included (cannot be excluded) when the debt is shed.

Common Threads

The four rules preventing double benefits have much in common. First, all of them are designed to prevent distortion of a taxpayer's true income picture—to prevent a false reflection of a taxpayer's true economic gain. To illustrate:

Rule 1: No deduction-deduction

Year 1: *T* pays $25 to repair a roof on business property, and deducts $25 in year 1 against income of $1,000. *T*'s taxable income thus is $975.

Year 2: A storm destroys the repair made in year 1. *T* has income of $1,000. *T* is not allowed a loss deduction for year 2 for the value of the repair. There has been an economic loss, but there has not been a tax loss because the deduction in year 1 left the repair with a basis of zero and section 165(b) limits a loss deduction to the basis of the lost property. If *T* were allowed to deduct the value of the re-

benefits received were excluded from gross income. The court held the taxpayer's deduction of the repayment was barred by *Skelly Oil*. The court noted that *Skelly Oil* was a double deduction case, but decided nevertheless that the "underlying principle" of *Skelly Oil* precludes a deduction for a repayment of an item excluded from gross income on receipt in a previous year. *Hintz* is discussed further *infra* note 75.

12 284 U.S. 1 (1931).

13 331 U.S. 1 (1947).

14 103 S. Ct. 1826 (1983).

pair against the year 2 income of $1,000, *T* would pay tax on only $1,950 over the two years, even though his economic gain for these years is $1,975.

Rule 2: No deduction-exclusion

Year 1: *T* contributes $25 to charity, and deducts it against gross income of $1,000. His taxable income is $975.

Year 2: *T* recovers $25 from the charity because of noncompliance with conditions of the charitable gift. His taxable income, apart from this transaction, is $1,000 for year 2. The recovery is gross income, and increases year 2 taxable income to $1,025. If *T* could exclude this $25 recovery, then over the two years *T* would have economic gain of $2,000, but would pay tax on only $1,975.

Rule 3: No exclusion-deduction

Year 1: *T*, with a basis of $60,000 in *Blackacre*, receives $50,000 from *X* in return for granting *X* the right to flood *Blackacre*. Because the potential damage to *T*'s land from the flooding easement cannot be ascertained, none of the $50,000 received from *X* is gross income.

Year 2: *T* sells *Blackacre* for $25,000. *T*'s gain is $15,000. *T*'s basis in *Blackacre* was reduced by $50,000 to $10,000 in year 1 because of his exclusion of the $50,000 received from *X*. If *T* were allowed to keep his old basis of $60,000 and thus had no gain on the sale in year 2, his economic gain of $15,000 from *Blackacre* (receipts of $50,000 and $25,000 less cost of $60,000) would go wholly untaxed.

Rule 4: No exclusion-exclusion

Year 1: *T* borrows $25 from banker B. The borrowed amount is not gross income.

Year 2: Banker *B* forgives *T*'s debt in order to retain *T* as a business client. If *T* were allowed to exclude the $25 debt discharge, his economic gain of $25 from the borrowing transaction would never be taxed.

These examples illustrate our first point, that the rules preventing double benefits are required to reflect a taxpayer's true economic picture.

The second point about the four rules proceeds from the first. Basically, the four rules are one rule and can be restated in much the same way as the Supreme Court restated the tax benefit rule in *Hillsboro*. The unifying principle of the rules is that of transactional consistency, and their unified purpose is to achieve what the Court in *Hillsboro* called "transactional equity."[15] All of these rules require that a taxpayer who has excluded a receipt or taken a deduction must treat subsequent events consistently with the exclusion or deduction, so as to achieve a transactional equity that prevents a false reflection of economic gain.

In *Hillsboro*, the Court rejected a reading of the tax benefit rule that would restrict its application to recoveries. The court broadened the rule to require an inclusion whenever a "later event is . . . fundamentally inconsistent with the premise on which the deduction was initially based."[16] We further broaden the tax benefit rule so that (1) it applies whether the prior benefit was a deduction or an exclusion, and (2) the reach of the rule is not limited to later inconsistent events, but extends to promote more generally the objective of consistency in the treatment of later events. For example, we say that Rule 3, which prevents exclusion-deduction, as in *Detroit Edison*, is based on the same principle as Rule 2, which prevents deduction-exclusion as in *Hillsboro*. In Rule 3, the prior tax benefit is an exclusion, and the deduction is denied in the later year not because an inconsistent event has occurred, but rather to give consistency with the earlier exclusion. Thus, in a Rule 3 case, just as in a Rule 2 case, the treatment in the later year is required to avoid a fundamental inconsistency with the treatment in the earlier year.

Our third and final point about these rules leads directly to the second part and burden of this article: All of these rules rest on the assumption that tax results which truly reflect economic gain always further, and never conflict with, congressional, administrative, or judicial tax policies. In the examples discussed above, and in many, perhaps most other cases, the paramount objective should be to reflect true economic gain. In several situations, however, this objective is, or at least arguably is, overridden by other policies. In these cases, as we show in Part Two, the proper result is achieved only by an inaccurate reflection of economic gain in contravention of the rules discussed above.

Part II

In General

The rules discussed in the preceding part prevent the unwarranted doubling of income tax benefits, and keep taxpayers' tax positions consistent with their economic positions. Nevertheless, in each of the categories discussed, there are exceptions or modifications that allow double benefits, and cause tax results that are inconsistent with taxpayers' economic positions. This phenomenon occurs when a congressional intent

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[15] *Id.* at 1146.

[16] *Id.* (footnote omitted).

to that effect can be discerned, either expressed or implied. There are instances where Congress has addressed the issue directly and has spoken clearly either for or against the allowance of double benefits. Sections 102 and 1014 illustrate the former, and sections 126(d) and 127(c)(7) are examples of the latter. There are other situations where the intent to allow double benefits can be implied, for example, where the disallowance of a deduction would deny an exclusion Congress clearly intended to give.

This Part of the article discusses situations, including some in each of the four categories described in Part One, in which double benefits are allowable. These situations are contrasted with those in which double benefits are disallowed.

An equally important purpose of this Part is to develop further the unifying principle which allows seemingly different categories to be analyzed under a single principle of law. As previously stated, we think that unifying principle is the tax benefit rule, as explained and defined in *Hillsboro National Bank v. Commissioner.*[17]

In other words, the rules against double benefits do not mechanically take away every double benefit. The question must be asked in each case whether the allowance of the second benefit is, in the words of the *Hillsboro* court, "fundamentally inconsistent" with the allowance of the first benefit. If the intent of Congress is that the second benefit be allowed, then, under the *Hillsboro* approach, there is no inconsistency in allowing the double benefit.

No Double Deduction for One Expenditure

Skelly Oil *Revisited*

The rule against double deductions is illustrated in Part I with *United States v. Skelly Oil Co.*[18] Assume the following example, a simplified version of the facts in *Skelly Oil*: A taxpayer purchases an oil lease for \$100,000. In year 1, it sells oil at a price set by a regulatory agency, recognizing gross income of \$20,000. It takes percentage depletion at the rate of 27.5% of gross income. In year 2, the price charged in year 1 is held invalid, and the taxpayer refunds to customers \$10,000 of the gross income of year 1. The Court held that only \$7,250 of the refund can be deducted for year 2 because a deduction of the last 27.5% (\$2,750) of the refund would duplicate the depletion deduction taken in year 1. If such a duplication were permitted, the Court noted, \$1.275 would be deducted for every dollar refunded.[19] The \$2,750 would be

[17] 103 S. Ct. 1134 (1983).
[18] 394 U.S. 678 (1969).
[19] *Id.* at 684.

deducted twice. Another way to explain the disallowance is to say that the basis in the refunded $10,000, for purposes of the year 2 deduction, is only $7,250 because only 72.5% of $10,000 is taxed on receipt and the tax cost of the receipt is thus only $7,250. Under section 165(b), a loss deduction is limited to the basis of the property lost—$7,250 in this case.[20]

In the words of the Court, "the Code should not be interpreted to allow respondent 'the practical equivalent of [a] double deduction,' . . . absent a clear declaration of intent by Congress."[21] The Court considered whether section 1341 demonstrated that intent. Section 1341 (a)(2) speaks of a "deduction" allowable in year 2 because the taxpayer did not have an unrestricted right to an "item." The "item" referred to in section 1341(a)(1) is the item included in gross income in year 1, here $10,000.

The taxpayer argued, and Justice Stewart agreed in dissent, that the deduction was in the amount of the item, $10,000, and could not, consistently with section 1341, be reduced under a double deduction theory.[22] The dissent made a related point that section 1341 is a relief provision for taxpayers in that it either reduces the tax for year 2 by the tax cost of the inclusion in year 1 or treats the repayment as a deduction in year 2, whichever is more favorable to the taxpayer. Therefore, in every case, the provision either makes the tax benefit of the repayment greater than the tax cost of the receipt (when the year 2 deduction is allowed), or gives the taxpayer a benefit larger than he would get if he were forced to deduct in year 2 (when the year 2 tax is reduced by the tax cost in year 1 of the inclusion).[23]

The majority said that repayments of depletable income, if fully deductible, would create a situation where "the taxpayer always wins and the Government always loses" and that such an "inequitable result" could

[20] *Id.* at 685 n.4. This analysis recalls the dissent in Perry v. United States, 160 F. Supp. 270 (Ct. Cl. 1958), *overruled by* Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967). The taxpayer had given property to a charity subject to a possibility of a reverter, and had taken a charitable deduction for the gift. The property was later returned to the taxpayer. The dissent argued (1) the taxpayer's deduction of the gift left the possibility of reverter with a zero basis and (2) the taxpayer's gain on the recovery of the property (amount realized on the recovery less basis) thus equalled the fair market value of the property when recovered. Following this analysis on the facts of the *Skelly Oil* example, the $2,750 denied as a deduction had no basis for deduction purposes. *See also* I.R.C. § 362(c) (property received as a contribution to corporate capital from one who is not a shareholder has a basis of zero).

[21] 394 U.S. 684, *quoting in part* Charles Ilfeld Co. v. Hernandez, 292 U.S. 62, 68 (1934).

[22] *Id.* at 682–83; *see also id.* at 693–94 (Stewart, J., dissenting).

[23] *Id.* at 692 n.1 (Stewart, J., dissenting).

not have been intended by Congress.[24] Justice Stewart dismissed this plaintive observation, saying section 1341 "is designed precisely to create" such a situation.[25]

The majority properly prevailed on this point. Justice Stewart's first assertion—that the deduction is measured by the item—finds no support in the language of the statute or the legislative history. The statute merely states that as a condition of its operation, a deduction must be allowable. It does not pretend to allow a deduction. That is the function of section 162 or 165.[26] The only advantage intended is with respect to tax rates and brackets; that is, section 1341 maximizes the tax relief by determining the benefit of the deduction at the taxpayer's tax rate in year 1 or 2, whichever is higher.[27] The statute was not intended to allow double deductions. Also, section 1341 changed the law only by its addition of section 1341(a)(5), the provision that reduces year 2 tax by the tax cost of the year 1 inclusion if this reduction is greater than the tax savings produced by a year 2 deduction. Skelly Oil took its deduction for year 2, following the rule of prior law embodied in section 1341(a)(4), for which no change was intended.[28]

Questions Unanswered by Skelly Oil

We endorse the methodology of *Skelly Oil* in searching for an overriding congressional intent to allow double deductions. The question is whether the Court went far enough in this direction. In the example, section 1016(a) reduces the basis in the lease by $2,750, the amount of the depletion deduction in year 1. The $2,750 that is untaxed in year 1 is a recovery of previously taxed capital, the outlay for the lease. The second deduction is for a separate and distinct outlay of $10,000. There is no double deduction of any one expenditure. The *Skelly* opinion does not allude to this, nor does it suggest that to the extent of the disallowed deduction, basis should be restored.[29]

Even though the double deduction prohibition is not operative in the

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[24] *Id.* at 686.

[25] *Id.* at 692 n.1 (Stewart, J., dissenting).

[26] *Id.* at 682–83.

[27] S. Rep. No. 1622, 83d Cong., 2d Sess. 451 (1954), indicates that § 1341 was enacted to reverse the result of United States v. Lewis, 340 U.S. 590 (1951), which held that a taxpayer who repaid money received and held under a claim of right was entitled only to a deduction in the year of repayment. *See generally* Rabinovitz, *Effect of Prior Year's Transactions on the Income Tax Consequences of Current Receipts or Payments*, 28 Tax L. Rev. 85, 112–15 (1972).

[28] S. Rep. No. 1622, *supra* note 27, at 118, 451.

[29] Justice Stewart flirts with the problem. He points out that adjusted basis is reduced by depletion, 394 U.S. at 695 n.5, but does not discuss the effect on basis of a disallowance of part of the deduction.

example, the tax benefit rule is. Repayment in year 2 is an event inconsistent with the percentage depletion deduction for year 1 to the extent of $2,750. Or, using an alternative test stated in *Hillsboro*, the tax benefit rule operates "if the occurrence of the event in the earlier year would have resulted in the disallowance of the deduction."[30] If, in the *Skelly Oil* example, the $10,000 refund had occurred in year 1, the refunded amount would not have been gross income,[31] and the percentage depletion deduction for year 1 would have been $2,750 less.

The gross income in year 2 under the tax benefit rule, however, is not necessarily $2,750. If cost depletion had been taken in year 1, the refund in year 2 would not be inconsistent with this deduction because cost depletion, like depreciation, is not measured by gross income.[32] Up to allowable cost depletion in year 1, the percentage depletion deduction gave no tax benefit that cost depletion would not have given. Assume that cost depletion for year 1 would have been $5,000. If the refunded $10,000 had been returned to customers in year 1, percentage depletion would have been only $2,750, and the taxpayer would have taken cost depletion of $5,000 instead. The latter figure is only $500 less than the percentage depletion of $5,500 actually taken. The refund is thus fundamentally inconsistent with only $500 of the deduction in

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[30] 103 S. Ct. at 1146. *See also id.* at 1143–44 ("[T]he tax benefit rule will 'cancel out' an earlier deduction only when . . . the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based. That is, if that event had occurred within the same taxable year, it would have foreclosed the deduction.")

[31] As authority for such an exclusion, one might cite Spitalny v. United States, 430 F.2d 195, 198 (9th Cir. 1970), and Anders v. United States, 462 F.2d 1147, 1149 (Ct. Cl.), *cert. denied*, 409 U.S. 1064 (1972). The taxpayers in those cases incurred costs in selling property incident to their liquidations, but, under § 337(a), recognized no gain or loss on the sales. Because the costs were recouped by sales made during the same year and because the sales were nonrecognition transactions, the court held the costs nondeductible.

In Fribourg Navigation Co. v. Commissioner, 383 U.S. 272 (1966), in contrast, the Supreme Court refused to disallow the depreciation deduction for the year depreciable property is sold, even though the deduction is recouped as additional gain on the sale and under the law then in effect this gain was taxed at capital gain rates. The taxpayer in Commissioner v. Anders, 414 F.2d 1283, 1288 (10th Cir. 1969), argued that the tax benefit doctrine did not require recognition of gain on a § 337 sale of fully expensed linens because the prior deduction of the costs of the linens was like the depreciation in *Fribourg Navigation*. The court disagreed, distinguishing *Fribourg Navigation* on the grounds that (1) depreciation allowances reflect actual wear and tear, whereas the taxpayer's linens had been expensed before they were used at all and (2) the depreciation in *Fribourg Navigation*, unlike the taxpayer's deductions, was not a deduction of the full cost of property.

[32] *See* Rabinovitz, *supra* note 27, at 111; 394 U.S. at 698 (Stewart, J., dissenting).

year 1. The taxpayer should therefore have only $500 of gross income in year 2 under the tax benefit rule. The basis of the lease should also be increased by $500 because the depletion deduction reduced basis in year 1.[33]

Skelly Oil ***and the Tax Benefit Rule***

The above discussion illustrates that the double deduction rule of *Skelly Oil* is not simple to apply, and should certainly not be applied mechanically to all seeming or apparent double deductions. Indeed, it was erroneously applied in *Skelly Oil* if, as in the example, the taxpayer had a basis other than zero for the depleted deposit and this basis was reduced by the depletion deduction in year 1. To remove any temptation to decide cases according to labels such as double deduction, and also to find a unifying principle, the analysis of double benefit cases should proceed entirely under the tax benefit rule. *Skelly Oil* itself noted the "analogous approach" of the tax benefit rule, citing *Alice Phelan Sullivan Corp. v. United States*[34] and section 111.[35] Under the tax benefit rule, the year 2 deduction should be disallowed to the extent it is fundamentally inconsistent with the deduction in year 2.

Hillsboro makes it quite clear that a fundamental inconsistency is not necessarily present in every double benefit case. Thus, the Court rejected its perception of the government's formulation of the tax benefit rule—that the rule prevails over all nonrecognition provisions.[36] The Court noted that the government's position implied, contrary to widely accepted decisions, that a previous deduction must be recaptured on a gift of an expensed item[37] or a transfer of expensed property at death.[38] In

[33] Under *Skelly Oil*'s double deduction theory, if the percentage depletion deduction were based on adjusted gross income rather than on gross income, the $10,000 refund, if fully deductible, would reduce year 2 adjusted gross income in that amount, and would thus automatically reduce year 2 depletion by $2,750. There would be no need to adjust the deduction of the refund. The Court noted this phenomenon and suggested this result, but found it had no application since depletion is, in fact, based on gross income. 394 U.S. at 686. *See generally* Rabinovitz, *supra* note 27, at 117–153 (discussing a variety of tax situations involving this refinement of *Skelly Oil*).

[34] 381 F.2d 399 (Ct. Cl. 1967).

[35] 394 U.S. at 686 n.5. Putoma Corp. v. Commissioner, 601 F.2d 734, 743 (5th Cir. 1979), also rejected the Commissioner's argument that the tax benefit rule applies "across the board."

[36] 103 S. Ct. 1134, 1145 (1983).

[37] *Id.* at 1145 n.20. For a discussion of the decided cases and rulings, see *id.* *See also* Carrington v. Commissioner, 476 F.2d 704 (5th Cir. 1973); Del Cotto, *Basis and Amount Realized Under Crane: A Current View of Some Tax Effects in Mortgage Financing*, 118 U. PA. L. REV. 69, 91 nn.112–14 (1969).

[38] *Cf.* Del Cotto & Joyce, *Inherited Excess Mortgage Property: Death and the Inherited Tax Shelter*, 34 TAX L. REV. 569 (1979).

particular, it cited *Campbell v. Prothro*[39] to illustrate the tension between the tax benefit rule and nonrecognition rules. *Prothro* is particularly relevant to *Skelly Oil* because it is also a double deduction case.

Campbell v. Prothro ***and the Allowable Double Deduction***

The taxpayer in *Campbell v. Prothro*[40] donated calves to a charity, which promptly sold them for cash. The costs of maintaining and raising the livestock had been deducted by the taxpayer, and he also took a charitable deduction for the value of the gift. The calves apparently were offspring of cattle owned by the taxpayer's ranching partnership, and there was no basis therein for depreciation.[41] The calves were apparently held for sale to customers in the ordinary course of the taxpayer's business.[42] The Commissioner included as ordinary income to the taxpayer the fair market value of the calves at the date of the gift. His theory, first stated in I.T. 3910[43] and I.T. 3932,[44] was that a gift of an ordinary income asset is a recognition event within the anticipatory assignment of income doctrine, as developed in *Helvering v. Horst*[45] and related cases. The Court held for the taxpayer, distinguishing *Horst* on the ground that in *Horst* the taxpayer had given a right to income (interest coupons) and kept the property (bond) that produced the income, whereas the taxpayer in *Prothro* transfererd both "principal and interest."[46] The net result was a double deduction: the deduction for the expense of raising the calves and the charitable deduction.

After *Prothro*, I.T. 3910 and I.T. 3932 were revoked by Revenue Rulings 55–138[47] and 55–531,[48] respectively. Revenue Ruling 55–138, however, requires adjustments to prevent double deductions.[49] It requires that the cost of inventory given to charity be removed from the taxpayer's inventory account. If an expensed item is given to charity, the ruling requires that deductions for expenses for the year of the gift be reduced by the cost of the item or that the charitable deduction be reduced by the amount deducted for the item in a prior year.

Section 170(e)(1)(A), enacted in 1969, avoids the double deduction

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39 209 F.2d 331 (5th Cir. 1954).

40 *Id.*

41 *Id.* at 332 n.2.

42 *Id.* at 333–34. *Cf.* I.R.C. § 1231(b)(3) for livestock held for breeding, dairy, or sporting purposes.

43 1948–1 C.B. 15.

44 1948–2 C.B. 7.

45 311 U.S. 112 (1940).

46 209 F.2d at 335.

47 1955–1 C.B. 223.

48 1955–2 C.B. 520.

49 Rev. Rul. 55–138, *supra* note 47, at 225.

in a different way: It disallows the charitable deduction for the ordinary income (including short-term capital gain) component in gifted property.[50] The congressional policy to allow the full deduction without recognition of unrealized gain thus has changed.

Nevertheless, the policy of Congress is to give a double benefit on a gift of expensed or appreciated property whenever section 170(e) does not apply. Section 170(a) gives a deduction for the value of property given to charity, even if its basis is much lower or even zero.[51] If the value exceeds basis because the property has appreciated, the rules exclude the unrealized appreciation from gross income, but allow the entire value, including the appreciation, as a charitable deduction. The policy to allow this double benefit logically extends to allow the double benefit of two deductions when the basis of property given to charity is zero because its cost has been expensed.[52]

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[50] Section 170(e)(1)(B)(i) disallows 40% of the amount that would have been capital gain on a sale of the property if (1) the property is tangible personal property that is unrelated to the purpose or function of the charity or (2) the donee is a private foundation. Also, the flush language of this subsection provides that § 1231(b) property (except for the portion of its value which would be ordinary income on sale under § 1245 or some other recapture rule) is treated as a capital asset. Thus, even if the calves in *Prothro* had not been inventory, but had instead been breeding or dairy stock (made subject to § 1231 by § 1231(b)(3)) outside of the scope of § 1245 (due to lack of depreciation), they would nevertheless be subject to § 170(e)(1)(B)(i) on a gift to the Y.M.C.A.

Section 170(e) was enacted because the prior tax consequences of a gift of ordinary income property—no tax on the appreciation in the property (appreciation that on sale would have been taxed at the taxpayer's top marginal rate), combined with a charitable deduction of this appreciation from other income (reducing tax at the taxpayer's top marginal rate)—was seen as too much of a good thing. Indeed, prior to reduction of the top marginal tax bracket to 50%, a prominent politician's gift to charity of his papers (which had a zero basis) produced a tax savings greater than the amount he would have had after taxes if he had (1) sold the papers, (2) been taxed on the proceeds of the sale as ordinary income, and (3) kept the after tax proceeds for himself. *See* STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, 91ST CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, at 77–79 (Comm. Print 1970).

Revenue Rulings 55–138 and 55–531, *supra* notes 47–48, have not been revoked despite the passage of § 170(e) in 1969. The adjustments required by Revenue Ruling 55–138, however, are not inconsistent with § 170(e). The requirement that the cost of inventory given to charity be removed from the donor's inventory account simply insures that this cost is not again deducted indirectly as a cost of goods sold. If a charitable gift is made of a normally expensed item, but Revenue Ruling 55–138 requires that the expensing deduction be denied, the item has a basis equal to its cost, and § 170(e)(1) reduces the charitable deduction only by the excess of value over cost. In a case where Revenue Ruling 55–138 reduces the charitable deduction for a gift of an item expensed in an earlier year, the ruling has the same consequence as § 170(e).

[51] Reg. § 1.170A–1(c)(1).

[52] *See generally* Del Cotto, *supra* note 37, at 91 n.114.

Section 170(e) usually takes this double deduction away because gain on a sale of expensed property is typically ordinary income and the thrust of section 170(e) is against ordinary income property. It is still possible, however, to get a double deduction for expensed capital gain property. Sections 1231(b)(3) and 170(e)(1) treat dairy cattle, for example, as capital gain property for this purpose. If a farmer deducts all costs of raising dairy cattle and then gives them to charity, a charitable deduction is allowed for the full value of the cattle, and there is thus a double deduction.[53] A double deduction can also be had by a charitable gift of depreciable real property. Suppose a taxpayer purchases an apartment building for $300,000, takes depreciation deductions on a straight line basis, and then contributes the property to a charity when its value is still $300,000. Under *Campbell v. Prothro,* the gift is not a taxable event. Also, the charitable contribution deduction is not reduced under section 170(e) because (1) there is no ordinary income under the recapture rules on a disposition of residential real property depreciated on a straight line method,[54] and (2) the building is thus section 1231(b) property to which section 170(e)(1)(A) does not apply.[55] These results are consistent with the intent of Congress to allow double benefits for charitable contributions. Also, under the tax benefit rule, the charitable gift is not an event fundamentally inconsistent with the depreciation deductions.

Haverly v. United States: Campbell v. Prothro *Revisited*

Suppose a law professor receives an unsolicited complimentary copy of a book from a publisher, uses it in preparing for his classes, and in a later year donates it to the law library of his school, taking a charitable contribution deduction for its then value. There was a similar scenario in *Haverly v. United States,*[56] where an elementary school principal received unsolicited sample textbooks in 1967 and 1968 in the hope he would use them in his curriculum. In 1968, he donated the books to the school library and took a charitable deduction for their value. As in *Haverly,* the Commissioner would require that the law professor include the value of the book in gross income because his use of the book and subsequent gift to charity are an exercise of dominion and control. The

[53] The charitable deduction is reduced by 40% in this case, however, unless the property is related to the donee's charitable function and the charity is not a private foundation. *See supra* note 50.

[54] There is no depreciation for § 1250(a)(1) to recapture since there is no "additional depreciation" within the meaning of § 1250(b)(1).

[55] I.R.C. § 170(e) (flush language).

[56] 513 F.2d 224 (7th Cir. 1975).

Seventh Circuit would uphold the Commissioner. *Receipt* of the book is a clear accession to wealth under *Commissioner v. Glenshaw Glass Co.*,[57] said the court, and the taking of the charitable deduction meets the further requirement of that case that the taxpayer have "complete dominion" over such wealth.

The problem of unsolicited samples was first addressed by the Service in Revenue Ruling 70–330,[58] which held that receipt and retention resulted in gross income under the *Glenshaw Glass* definition. No gift to charity was involved. This ruling was superseded by Revenue Ruling 70–498,[59] where the facts were the same as in the earlier ruling, except the books were the subject of a deducted charitable contribution. The books were held to be gross income to the extent of their value when received, a result cited and discussed with approval in *Haverly*.[60]

The court in *Haverly* said the taxpayer had gross income because he gave the books to charity and deducted the gift. This seemingly conflicts with *Campbell v. Prothro*, which held that the making of a charitable gift did not trigger income recognition, and yet *Prothro* is not discussed in the *Haverly* opinion. Perhaps, *Prothro* was not mentioned because in *Haverly*, unlike *Prothro*, there was no clearly apparent double deduction. In fact, however, there is a double deduction in cases like *Haverly*. The entire scenario in the law professor example might be as follows: (1) Upon receipt of the book, the law professor has gross income in the amount of the value thereof under section 61 and *Glenshaw Glass*.[61] (2) As a result, he acquires a tax cost basis equal to this value[62] and takes a deduction under section 162(a) equal to the basis,[63] thereby

[57] 348 U.S. 426, 431 (1955).

[58] 1970–1 C.B. 14.

[59] 1970–2 C.B. 6.

[60] The amount of the income in *Haverly v. United States, supra* note 56, was not in issue since the value of the books was stipulated to have been $400 both on receipt and at the time of the gift. If the book declined in value—if it were, for example, a copy of the Internal Revenue Code, new when received but quite dated when given to charity a year later—and if the taxpayer exercised dominion over the book only by his act of giving it away and taking a charitable deduction for the gift, apparently only the lesser value at the time of the gift would be gross income under *Haverly*.

[61] *See* Rev. Rul. 70–330, *supra* note 59.

[62] Philadelphia Park Amusement Co. v. Commissioner, 126 F. Supp. 184 (Ct. Cl. 1954).

[63] The regulations do not require capitalization and depreciation for assets with short lives or small costs, such as short lived books (Reg. § 1.162–6), farmers' tools (Reg. § 1.162–12, *but see* I.R.C. § 464), materials and supplies (Reg. § 1.162–3). *See generally* 4 Bittker, Federal Taxation of Income, Estates and Gifts ¶ 20.4.1 (1981) (discussing the above regulations). The court in *Hillsboro* ascribes to these regulations the purpose of relieving taxpayers of the accounting burden of capitalizing or inventorying such items by allowing them an

washing out the income.[64] (3) On the transfer to the charity, a second deduction is taken. So viewed, *Haverly* is *Campbell v. Prothro* in slightly different garb, and the result should be the same as in *Prothro.*[65]

No Exclusion of Receipt of Item Previously Expensed

Hillsboro *Revisited*

This rule is illustrated in Part I mainly with *Hillsboro National Bank v. Commissioner.*[66] Of the two cases consolidated for review in *Hillsboro,* only one is of interest here. In that case, a corporation operated a dairy and in year 1 deducted the entire cost of the cattle feed purchased for use in operations. Two days into year 2, the taxpayer adopted a plan of liquidation and distributed its assets, including a substantial portion of the feed deducted in year 1, to its shareholders in a section

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expense deduction on purchase. 103 S. Ct. at 1144 n.17. The regulations were also approved in Gudmundsson v. Commissioner, 37 T.C.M. (CCH) 1249 (1978). Section 179 gives relief comparable to these regulations.

[64] The wash effect described in the text could also be obtained by analyzing the transaction as though the professor had ordered the book, was billed for it, and the bill had been forgiven to induce him to order books from the publisher for his classes. Under section 108(e)(2), the discharge of the debt would not be gross income because the payment of the liability would have given rise to a deduction. The effect of section 108(e)(2) is to treat the professor as though he had paid his bill, deducted the amount paid, and then received the payment back as gross income.

[65] Does section 170(e)(1)(A) greatly reduce the significance of the issue for years after 1969? The expensing of an item leaves it with a zero basis, and gain on a sale of an expensed item has been held to be ordinary income, not protected by § 337. *E.g.,* Anders v. United States, 462 F.2d 1147 (Ct. Cl. 1972). *See also* Merchants National Bank v. Commissioner, 199 F.2d 657 (5th Cir. 1952). Section 170(e)(1)(A), which reduces the charitable deduction by the ordinary income that would have been realized on a sale of the gifted property, thus arguably reduces the deduction for a charitable gift of expensed items to zero.

There is an argument, however, that § 170(e)(1)(A) does not apply to an expensed item used in a taxpayer's trade or business. Under § 170(e)(1), "property which is property used in the trade or business (as defined in section 1231(b)) shall be treated as a capital asset," except to the extent gain on sale would be ordinary under the recapture rules. Sections 1245 and 1250 do not apply to recapture the gain potential since expensing has been held not to be a method of depreciation. *E.g.,* Hillsboro National Bank v. Commissioner, 103 S. Ct. 1134, 1151 (1983); Commissioner v. Anders, 414 F.2d 1283 (10th Cir. 1969). Section 1231(b), in turn, does apply because it refers to property used in business "of a character which is subject to the allowance for depreciation." Arguably, an expensed item used in business is of a "character" subject to depreciation, even though depreciation deductions are not allowed because basis is zero. Gain on a sale of an expensed item therefore is arguably characterized by § 170(e)(1) as a capital asset.

[66] 103 S. Ct. 1134 (1983).

333 liquidation. The Commissioner required the corporation to take into income the value of the grain distributed under the tax benefit rule. He argued that no "recovery" of a previously deducted item was necessary to make the tax benefit rule applicable, only an event which is "inconsistent with the past deduction" and which, if it had occurred in the earlier year, would have resulted in a disallowance of the deduction.[67]

The Supreme Court upheld the Commissioner's view, finding that the purpose of the tax benefit rule is not simply to tax "recoveries," but "to approximate the results produced by a tax system based on transactional rather than annual accounting"[68]—in other words, to do "transactional equity."[69] Thus, the tax benefit rule is triggered when a later event is "fundamentally inconsistent with the premise on which the deduction was initially based."[70] The distribution of the expensed assets was held to be inconsistent with the earlier deduction because the deduction was premised on the assumption that the grain would be consumed in the corporation's business. Failure to so consume it would be the same as selling it at a zero basis in order to recognize the gain from the recovery.[71] Similarly, converting the asset to a nonbusiness use would be

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[67] Revenue Ruling 74–396, 1974–2 C.B. 106, a progenitor of *Hillsboro*, applies the "inconsistent event" doctrine to expensed items distributed in any corporate liquidation governed by §§ 331, 333, or 346 (partial liquidation, the modified provisions of which are now in §§ 302(b)(4) and 302(e))—that is, to any liquidating distribution where the shareholders take a fair market value basis (§ 331 and 334(a)) or a substituted cost basis (§§ 333 and 334(c)). In any of these situations, the shareholder's basis is independent of the corporation's zero basis in the item, and the income offset by the corporation's deduction for the item is forever exempted from tax unless the corporation is taxed under the tax benefit doctrine at the time of the distribution.

If, however, the liquidating corporation is an 80% or more controlled subsidiary of another corporation and § 332 applies, § 334(b)(1) gives the shareholder a carryover basis and causes it to become the surrogate for recapture by acquiring the subsidiary's tax attributes under § 381(a)(1) and 381(c)(12). Therefore, the tax benefit doctrine should not apply to the liquidating distribution in such a case. Revenue Ruling 74–396 so states in distinguishing a § 332 liquidation which is subject to § 381, from a § 331 or § 333 liquidation.

[68] 103 S. Ct. at 1142.

[69] *Id.* at 1146.

[70] *Id.* at 1143.

[71] *Id.* at 1150. Here the Court relies on Spitalny v. United States, 430 F.2d 195 (9th Cir. 1970), one of a number of cases that hold that the tax benefit rule overrides § 337. *See, e.g.*, Anders v. United States, 462 F.2d 1147 (Ct. Cl.) *cert. denied*, 409 U.S. 1064 (1972); Commissioner v. Anders, 414 F.2d 1283 (10th Cir.) *cert. denied*, 396 U.S. 958 (1969); West Seattle Nat'l Bank v. Commissioner, 288 F.2d 47 (9th Cir. 1961). *See also* Hillsboro Nat'l Bank v. Commissioner, 103 S. Ct. at 1153 (citing Connery v. United States, 460 F.2d 1130 (3rd Cir. 1972); Krajeck v. United States, 75–1 U.S.T.C. ¶ 9492 (D.N.D. 1975); S.E. Evans, Inc. v. United States, 317 F. Supp. 423 (D. Ark. 1970); Estate of Munter v. Commissioner, 63 T.C. 663 (1975)).

inconsistent with the prior deduction.[72] The distribution in liquidation, held the Court, "turns the expensed assets to the analog of personal consumption." [73]

However, an inconsistent event is not enough to invoke the tax benefit rule, held the Court, if there is a nonrecognition provision in the picture.[74] In such a case, there is the further question of whether the nonrecognition rule overrides the tax benefit rule. The Court held that section 336, which provides corporate nonrecognition of gain or loss on the distribution of property to shareholders in liquidation, was not an overriding provision because it was intended only to apply to unrealized gains and losses, not to gain realized by a prior deduction.[75] In other words, no double benefit (deduction and exclusion) was intended by Congress in enacting section 336; therefore, an exclusion in year 2 would have been inconsistent with the year 1 deduction. Also, a liquidation in year 1 would have caused denial of the deduction.

Commissioner v. American Dental Co.:
Tension Between Tax Benefit Rule and
Section 102

The Court in *Hillsboro* recognized that an inconsistent event in the context of a nonrecognition rule creates an "inherent tension" [76] between

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[72] 103 S. Ct. at 1150.

[73] *Id.* at 1150 .

[74] Mager v. United States, 499 F. Supp. 37 (M.D. Pa. 1980), held that the tax benefit rule overrides § 1033. The court notes the tension created by the nonrecognition provision, but holds against the taxpayer without significant discussion.

[75] 103 S. Ct. 1150–51. Compare Hintz v. Commissioner, 712 F.2d 281 (7th Cir. 1983), discussed *supra* note 11, where the apparent congressional intent embodied in 45 U.S.C. § 352(e) and (f) was to allow an exclusion for sick pay and unemployment insurance benefits only when they were not reimbursed by the employer. *See also* Canelo III v. Commissioner, 53 T.C. 217, 226–27 (1969), *aff'd on other grounds*, 447 F.2d 484 (9th Cir. 1971), which held that a recovery of litigation costs improperly deducted in a year barred by the statute of limitations was not a taxable recovery under the tax benefit rule. The tax benefit rule, said the Tax Court, taxes a recovery only if the initial deduction was proper. When it is improper, the Commissioner's remedy is to challenge the deduction before the year is barred. 53 T.C. at 226–27. Sections 1311 through 1314, which mitigate the statute of limitations, were held not to apply. *Id.* at 227.

Unvert v. Commissioner, 656 F.2d 483, 486 (9th Cir. 1981), however, rejected *Canelo* and refused to recognize an improper deduction exception to the tax benefit rule. A deduction taken with tax benefit, whether or not proper, is all that is necessary, according to the *Unvert* court. The deduction causes the taxpayer's entitlement to a recovery of the deducted item to lose "its nature as capital," suggesting lack of basis in the claim. Also, the erroneous deduction exception was held to be poor public policy because improper deductions "should not be rewarded," that is, should not receive treatment preferential to those taken properly.

[76] 103 S. Ct. 1144–45, 1145 n.20.

the tax benefit and nonrecognition rules which can be resolved only by making a determination of congressional intent. The Court said: "It has long been accepted that a taxpayer using accrual accounting who accrues and deducts an expense in a tax year before it becomes payable and who for some reason eventually does not have to pay the liability must then take into account the amount of expense earlier deducted."[77] Because the deduction in such a case is obviously premised and conditioned upon eventual payment of the expense, the Court's conclusions as to the consequences of failing to make the payment appear sound. The more difficult case arises when the liability is terminated in a nonrecognition transaction.

In *Commissioner v. American Dental Co.*,[78] the taxpayer accrued and deducted rent and interest expense and in a later year, when the taxpayer was fully solvent, its creditors cancelled part of the debt. The Commissioner increased the taxpayer's gross income by the amount of debt discharged. The Supreme Court held, however, that the forgiveness was a gift, "a release of something to the debtor for nothing."[79] "The fact," said the Court, "that the motives leading to the cancellations were those of business or even selfish, if it be true, is not significant" so long as the debtor paid no consideration therefor.[80]

The standard used by the Court to find a gift resembles the gift tax definition thereof,[81] but flies in the face of the later holding of the Court in *Commissioner v. Duberstein*[82] that a transfer is a gift for income tax purposes only if it proceeds from detached and disinterested generosity.[83] Nevertheless, it is theoretically possible for debt discharge to arise from detached and disinterested generosity.[84] If the creditors in *American Dental Co.* did have that motive, the exclusion of an item previously deducted is not an event inconsistent with the past deduction, and, as that case held, the tax benefit rule is preempted by the section 102(a) gift exclusion. The entire transaction has the same effect as if the debt (interest and rent) were paid to the creditors and the proceeds were transferred back as a gift excludable under section 102(a). The exclu-

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[77] *Id.* at 1142.

[78] 318 U.S. 322 (1943).

[79] *Id.* at 331.

[80] *Id.*

[81] I.R.C. § 2512(b).

[82] 363 U.S. 278 (1960).

[83] Indeed, the Court retreated from *American Dental Co.* in Commissioner v. Jacobson, 336 U.S. 28, 50 (1949), where bonds were purchased at a discount in an arm's length transactions, the Court holding that there was no gift within the predecessor of § 102(a) since the bondholder and taxpayer each pursued the best price that could be had.

[84] *See, e.g.*, Bosse v. Commissioner, 29 T.C.M. (CCH) 1772 (1970); Clem v. Campbell, 62–2 U.S.T.C. ¶ 9786 (N.D. Tex., 1962).

sion is not inconsistent with the deduction; both were intended to be allowed by Congress.

Putoma Corp. v. Commissioner: *Tension Between Tax Benefit Rule and Section 118*

A gratuitous forgiveness by a shareholder of a debt owed him by a corporation is a contribution to the corporation's capital, the regulations say, equal to the principal amount of the debt.[85] The reference to principal amount implies that a corporation has gross income when its shareholder forgives interest, but the courts have rejected this distinction. In *Putoma Corp. v. Commissioner*,[86] the corporation accrued and deducted interest owed to its 50% shareholder, and in a later year the shareholder forgave the interest debt. The court found there was a contribution to capital even as to forgiven and previously deducted interest.[87] Therefore, under section 118(a), which generally excludes contributions to capital from corporate income, the cancellation of the interest was not gross income to the corporation, and the tax benefit rule could not apply. The court also held that under the Supreme Court's decision in *American Dental*, the discharge of the debt was excluded by section 102 as a gift.

The result appears manifestly correct since if the corporation had paid the interest and received the payment back as a capital contribution, the cash receipt would be excluded by section 118, and the deduction for the interest would not have been affected. Congress intends this result, and there is no inconsistency with the past deduction. Nevertheless, section 108(e)(6), added in 1980,[88] reversed *Putoma* by requiring an accrual method corporation to recognize debt discharge income when accrued interest is forgiven by a cash method shareholder.[89]

Section 108(e)(6) apparently derives from a dissatisfaction with the *Putoma* court's treatment of the shareholder.[90] The government argued alternatively in the Tax Court in *Putoma* that if the corporation were not to be taxed on the discharge, the shareholder should be because the

[85] Reg. § 1.61–12(a).

[86] 601 F.2d 734 (5th Cir. 1979).

[87] *Accord* Hartland Associates v. Commissioner, 54 T.C. 1580 (1970) (citing American Dental Co. v. Commissioner, 318 U.S. 322 (1943)); Commissioner v. Auto Strop Safety Razor Co., 74 F.2d 226 (2d Cir. 1934), *aff'g* 28 B.T.A. 621 (1933); McConway & Torley Corp. v. Commissioner, 2 T.C. 593 (1943); George Hall Corp. v. Commissioner, 2 T.C. 146 (1943)).

[88] Pub. L. No. 96–589, § 2(a), 94 Stat. 3389, 3393 (1980).

[89] More specifically, the rule is that when a shareholder contributes a corporate debt to the corporation's capital, (1) the corporation is treated as having satisfied the debt for a cash payment equal to the shareholder's basis for the debt and (2) the excess of the debt over the shareholder's basis is income from discharge of indebtedness that is not excluded from gross income by § 118.

[90] S. REP. No. 1035, 96th Cong., 2d Sess. 18 (1980).

corporate deduction should be matched with shareholder gross income.[91] The Service lost in the Tax Court on this point and appealed, but the appeal was later dismissed by the Fifth Circuit at the government's request.[92] The government apparently followed the advice of the Tax Court "to seek symmetry in another forum."[93] The apparent effect of section 108(e)(6) is to give that symmetry, to make the exclusion of section 118 inapplicable so that the corporation is taxed on the discharge. Although the shareholder apparently avoids tax, he seemingly does also not get an upwards basis adjustment for his stock.

Section 108(e)(6) is wrong-headed and short-sighted. It is wrong-headed because it deems an event (a contribution to capital) to be what it is not, turning an event with economic reality into an unreal event in order to collect a tax.[94] It is short-sighted in many respects.

First, the provision is not integrated with section 267(a)(2), which denies an accrual method corporation's deduction for interest owed to a greater than 50% shareholder if the shareholder uses the cash method and the interest is not paid within two and one-half months after the close of the year in which the interest accrues. Since section 108(e)(6) literally does not require a deduction, the effect of the two sections may be to both deny the interest deduction to the corporation under section 267(a)(2) and charge the corporation with debt discharge income under section 108(e)(6).

Second, section 108(e)(6) might possibly be avoided if the shareholder takes back stock equal in value to the amount discharged because the provision states only that "section 118 shall not apply" and it is section 1032(a) that excludes from gross income the consideration received on an issue of stock. If the shareholder takes back stock, furthermore, the transaction is not the same as in *Putoma* because there a 50% shareholder forgave interest due him without taking back stock, thereby shifting one half of the benefit of the discharge to other shareholders. Therefore, it would be difficult to equate a discharge in exchange for stock with *Putoma* in order to invoke section 108(e)(6), unless the shareholder owned 100% of the stock.

Third, suppose the corporation in fact paid the interest to the shareholder and the shareholder returned the payment as a contribution to capital. This transaction does not fall literally within section 108(e)(6) since it is not the "indebtedness" which is contributed to capital. Never-

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[91] 66 T.C. at 669–72.

[92] 601 F.2d at 741.

[93] 66 T.C. at 671.

[94] *See, e.g.*, I.R.C. § 636, discussed in Joyce & DelCotto, *The AB (ABC) and BA Transactions: An Economic and Tax Analysis of Reserved and Carved-Out Income Interests*, 31 TAX L. REV. 121, 156–162, 179–182 (1976).

theless, would the step transaction doctrine collapse the two steps into a debt discharge subject to section 108(e)(6)? It should not, since the payment of the interest would give the shareholder interest income, and section 108(e)(6) seems designed only to compensate for the lack of a shareholder tax. If the step transaction doctrine is not applied, however, taxpayers are offered a choice between a corporate tax (the result of a contribution of the debt) and a tax on shareholders (the consequence of a payment of the interest followed by a contribution of the payment). Is it wise to give such a choice?

Fourth, section 108(e)(6) invokes the debt discharge rules rather than the tax benefit rule to tax the corporation. Although we argue below that these rules operate in the same way and for the same reasons, there is a great deal of confusion about the relationship between them.[95] It might not be seen that part or all of the corporate interest deduction is within the recovery exclusion of section 111.[96]

There is a further problem. The Senate Finance Report says that the *Putoma* result should not be reached on the alternative ground that the shareholder made a gift to the corporation since "it is intended" that there will not be any gift exclusion in a commercial context to the general rule that debt discharge gives rise to income.[97] This attempt to amend section 102 by committee report rather than by statute is doubly strange in that the attempt is made in the report on section 108, a most unlikely place for it.[98] Also, the attempted amendment is the very position of the government which was rejected by the Supreme Court in *Commissioner v. Duberstein*[99] and discussed at length in *Putoma*.[100]

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[95] *See generally* Putoma v. Commissioner, 66 T.C. 652 (1976); BITTKER, *supra* note 63, at ¶ 6.4.5.

[96] Rev. Rul. 67–200, 1967–1 C.B. 15; Rev. Rul. 70–406, 1970–2 C.B. 16. *See generally* BITTKER, *supra* note 63, at para. 6.4.5. n.71.

[97] S. REP. No. 1035, *supra* note 90, at 19. The *Putoma* opinion uses §§ 118 and 102 as alternative grounds for the corporate exclusion, but it is not clear that § 102 was not independently necessary because the forgiving shareholder did not take back stock in exchange for the discharge, and the discharge thus benefited the other 50% shareholder.

[98] Compare H.R. REP. No. 760, 97th Cong., 2d Sess. 545 (1980) (Conf. Rep.) (committee report on § 302(c)(2)(C), which allows entities the benefit of the attribution waiver provided by § 302(c)(2)(A), states that the *statute* is intended to overrule Rickey v. United States, 592 F.2d 1299 (5th Cir. 1979)). *See also* STAFF OF THE JOINT COMMITTEE ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 153–54 (1976), *reprinted in* 1976–3 (vol. 2) C.B. 166 (committee report pertaining to the repeal of § 422, relating to qualified stock options, states congressional intent with respect to the future application of § 83 although nothing in the statute amended § 83 in any way.)

[99] 363 U.S. 278 (1960).

[100] 601 F.2d at 748.

Apparently, what the government does not get in the courts or statutes, it takes by committee report.

Even if the attempted amendment is given effect, a debt discharge given to an accrual method, noncorporate business debtor appears still to be within the rule of *Putoma* if the discharge is a gift within the disinterested generosity test of *Duberstein*. Assume a sole proprietor borrows money from an unrelated friend to by business assets, and accrues and deducts the interest on the loan; the friend subsequently forgives the interest as a gift. There is no reason why the taxpayer should not have both the deduction and the exclusion.[101] The gift does not arise from a commercial relationship. The gift exclusion is not inconsistent with the prior interest deduction.

Reimbursement Doctrine

Another aspect of the deduction-exclusion problem is illustrated by tax-free reimbursements of items that would otherwise be deductible. In *Manocchio v. Commissioner*,[102] the taxpayer took a flight training course and deducted the entire cost as educational expense allowable under section 1.162–5 of the regulations. As a veteran, the taxpayer was entitled to an allowance of 90% of the cost under veterans' assistance legislation. This allowance is exempted by statute from tax.[103] The allowance was paid to the taxpayer during the year that he incurred and deducted the cost. The Tax Court denied 90% of the deduction under section 265(1), on the ground that that portion of the expense was "allocable to" the tax-exempt reimbursement.[104] The Ninth Circuit affirmed, agreeing that 90% of the cost was nondeductible, but relying instead on the principle that an otherwise deductible expense cannot be deducted if it is reimbursed. The rationale for the reimbursement theory is that to the extent of reimbursement, there has been no expense.[105]

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[101] In this situation, the forgiveness of the debt for accrued interest (even though accompanied by a forgiveness of the principal) should require the friend-creditor to include the accrued interest in income under assignment of income principles. Smith's Estate v. Commissioner, 292 F.2d 478 (3d Cir. 1961). This is the alternative argument made by the government in *Putoma*, an argument rejected by the Tax Court, and abandoned in appeal to the Fifth Circuit—all of which led to the enactment of § 108(e)(6). *See supra* note 94 and accompanying text.

[102] 710 F.2d 1400 (9th Cir. 1983).

[103] 32 U.S.C. § 3101(a) (1976), which states: "Payments of benefits . . . under any law administered by the Veterans' Administration . . . shall be exempt from taxation."

[104] 78 T.C. 989, 992–96 (1982), *aff'd*, 710 F.2d 1400 (9th Cir. 1983). The relationship of § 265(1) to the deduction-exclusion problem is discussed *infra* at notes 153–57 and accompanying text.

[105] 710 F.2d at 1402.

The same result obtained in *Banks v. Commissioner*,[106] where the Veterans Administration paid the taxpayer's tuition and book expenses directly. The payments were tax exempt to taxpayer, and this exemption, the Tax Court held, precluded a deduction. "No income was taxed which was devoted to the expense."[107] This reasoning seems to have basis implications; that is, since the expense was paid with zero basis dollars, there is no tax deduction. But the court also said that there was no expense from a tax standpoint.[108] This is the reimbursement theory of *Manocchio*. The Tax Court further stated that the disallowance was necessary to prevent the "effect" of giving the taxpayer a "double deduction for one item,"[109] meaning, apparently, a deduction plus an exclusion.

The taxpayer in *Wolfers v. Commissioner*[110] was reimbursed for relocation expenses under a federal statute which provided that the reimbursement was not to be "considered as income." The Tax Court held that the reimbursed expenses were not deductible, relying in part upon *Charles Baloian Co. v. Commissioner*,[111] which also held that a tax-exempt relocation reimbursement prevented a moving expense deduction.

These reimbursement cases could also be analyzed with the approach suggested in *Hillsboro*. The question could be asked, "Is an exclusion for the reimbursement inconsistent with the deduction?" If so, and if the expenditure is reimbursed in the year it is made or there then exists a reasonable claim for reimbursement, there should be no deduction, as noted in *Hillsboro*.[112] On the other hand, if the recovery is in a later year, the proper relief is to treat the recovery as gross income up to the amount of the past deduction.[113]

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[106] 17 T.C. 1386 (1952).

[107] *Id.* at 1393.

[108] *Id.*

[109] *Id.*

[110] 69 T.C. 975, 981 (1978) (construing 42 U.S.C. § 4636 (1976)).

[111] 68 T.C. 620 (1977), *nonacq., reviewed* (1 dis.).

[112] 103 S. Ct. 1134, 1146 (1983). *See also* Spitalny v. United States, 403 F.2d 195, 198 (9th Cir. 1970); Anders v. United States, 462 F.2d 1147, 1149 (Ct. Cl.), *cert. denied*, 409 U.S. 1064 (1972); Rev. Rul. 71-160, 1971-1 C.B. 75; Reg. § 1.165-1(d)(2)(i). Apparently, the courts do not distinguish between cash method and accrual method taxpayers, even though there is an argument that accrual of a right to later reimbursement should not prevent a deduction to a cash method taxpayer. Canelo v. Commissioner, 447 F.2d 484, 485 (9th Cir. 1971) (citing Burnett v. Commissioner, 356 F.2d 755 (5th Cir.), *cert. denied*, 385 U.S. 832 (1966), and Hearn v. Commissioner, 309 F.2d 431 (9th Cir. 1962), *cert. denied*, 373 U.S. 909 (1963)).

[113] Hillsboro Nat'l Bank v. Commissioner, 103 S. Ct. at 1140 n.10; Reg. § 1.165-1(d)(2)(iii); Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967); Rev. Rul. 71-160, 1971-1 C.B. 75. See also the position of the Commissioner in Charles Baloian Co. v. Commissioner, 68 T.C. 620 (1977).

Under the tax benefit rule, then, the underlying question raised by the reimbursement doctrine, where the reimbursement is tax exempt, is whether the reimbursement is inconsistent with allowance of the deduction. To put it another way, does denial of the deduction thwart any congressional policy with respect to the exclusion? Denial of the deduction leaves the taxpayer in much the same economic position as an allowance of the deduction and a denial of the exclusion for the reimbursement. The Tax Court noted this in *Manocchio*, but said that denial of deduction did not abrogate the veteran's tax exemption of the flight training benefit.[114] Apparently, the court thought the deduction and exclusion issues were not tied because not all expenses subject to reimbursement could be deducted with tax benefit in the absence of reimbursement; some educational costs do not qualify for deduction, and some reimbursed taxpayers do not have sufficient itemized deductions to take advantage of an available deduction.

This, however, is only to say that some veterans have the exclusion and some do not. Those who are denied a deduction are effectively denied the exclusion because the effect of the denial of the deduction is the same as allowing the deduction and taxing the reimbursement. In any event, those who have no deduction receive the exclusion. In *Manocchio*, the recovery was, by federal statute, "exempt from taxation," and it is not enough to say the exemption is preserved if it is preserved haphazardly, for some but not all taxpayers. Nor is it enough to say, as the court did in *Wolfers*, that the exemption statute was drafted by committees of Congress not familiar with tax legislation, or that the statute involved was not couched in the traditional "exclusion" language of Code.[115]

If Congress intends a permanent exclusion, the taxpayer must have a basis for the excluded receipt equal to its fair market value, and any expense paid with the property so received must be deductible if it falls within a deduction rule, applied without regard to the receipt. To hold —as did *Mannocchio* and the other cases discussed above—that the reimbursement makes the expense nondeductible is equivalent to holding that the property received takes a zero basis; when there is no basis, nontaxation of the receipt is merely a deferral. The effect is the same as receiving a gift of property having a zero basis to the donor. When the property is sold, its value when given becomes income, and the combina-

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114 78 T.C. at 997. The point was also raised in *Wolfers*, but was not discussed by the Tax Court.

115 69 T.C. at 982. The statute said: "No payment received . . . shall be considered as income for purposes of the Internal Revenue Code of 1954." *See supra* note 118.

tion of sections 102(a) (exclusion) and 1015(a) (carryover basis) results in only deferral. If the same property is inherited, the section 102 exclusion is truly that because section 1014(a) gives permanent relief from tax through a fair market value basis. Certainly, one who receives a check for tax-free municipal bond interest and endorses it over to pay his real estate taxes has both an exclusion (section 103) and a deduction (section 164) because section 103 is truly an exclusion section and not a deferral section. It gives tax-free basis.[116]

It appears, then, that when Congress wants an exclusion to be only a deferral, it attaches a basis section so indicating. The combinations of sections 109 and 1019, 108 and 1017, 1031(a) and (d), and 1034(a) and (e) have this effect. This list is not exhaustive, but it illustrates clearly that an excluded amount of cash must have a full basis unless Congress says otherwise. Without basis, there is deferral, not exclusion. Thus, the language in the *Banks* opinion intimating lack of basis in the dollars recovered is erroneous. And, the "double deduction" observation fails to see that double benefits are permitted where intended by Congress. In *Manocchio*, the Tax Court makes another exclusion rule function only as a deferral rule.

The deduction is denied, the court said in *Manocchio*, "where, but for the expense, there would simply be no exempt income,"[117] in other words, where the payment is earmarked for the expense. But, suppose a parent makes a gift to a child to allow the child to pay for advanced schooling, the cost of which is deductible. A similar problem was addressed by the Tax Court in *Shanahan v. Commissioner*,[118] where the taxpayers received a loan from the Small Business Administration to repair their home, which had been damaged by an earthquake. In the same year, a portion of the loan obligation was cancelled under the Disaster Relief Act of 1970. The taxpayers argued the cancellation was a gift, exempt under section 102(a), and was not compensation for the loss within the meaning of the provision of section 165(a), which makes nondeductible any loss "compensated for by insurance or otherwise." The Tax Court found no detached and disinterested generosity on the part of the government, but rather a sense of obligation. Therefore, the

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[116] Also, § 705(a)(1)(B) steps up the basis of a partnership interest for a partner's share of tax-exempt income of the partnership. The addition to basis made is so that the benefit of such tax-exempt income will not be lost to the parties. Otherwise, the partner would eventually incur a capital gains tax with respect to these amounts. H.R. REP. No. 1337, 83d Cong., 2d Sess. 324–25 (1954). *Accord* S. REP. No. 1622, 83d Cong., 2d Sess. 384 (1954). The partner thus has both an exclusion and a deduction, that is, a basis offset in a sale under § 1001.

[117] 78 T.C. at 994.

[118] 63 T.C. 21 (1974).

debt discharge was held to be compensation which reduced the taxpayers' casualty loss deduction.[119]

In contrast, Revenue Ruling 64–329 [120] held that a gift to an uninsured disaster victim by relatives and neighbors was not compensation and did not reduce the casualty loss deduction, even though the funds received were used to repair the damage. The ruling distinguished Revenue Ruling 131,[121] which held a transfer by an employer to employee disaster victims was compensation since there the money received had to be used for repairs. In Revenue Ruling 64–329, on the other hand, "there was no limitation or directive relating to the manner in which the money was to be used by the recipient." [122] This is the test applied by the Tax Court in *Manocchio*.[123]

No Deduction for Items Previously Excluded

Sections 1032, 118, and 362(c)

A leading Supreme Court case illustrating this principle is *Detroit Edison Co. v. Commissioner*.[124] The taxpayer had excluded from gross income as capital contributions payments received from nonshareholders.[125] The Court held that the basis of the assets acquired with the payments was zero because the taxpayer had no "cost" for the property. In other words, the corporation could not acquire a basis for future depreciation deductions when none of its cost had been included in gross income.[126] Since 1954, this principle has been codified as section 362(c).

Section 362(c), however, is an exception to the general rule. Section 362(a) provides that if property is received from a shareholder as a contribution to capital or in exchange for stock or securities in a transaction encompassed by the shareholder nonrecognition rule of section 351, the corporation's basis for it is the sum of the shareholders' basis and any gain he recognized on the transfer. If property is received in exchange

[119] *Id.* at 26. *Accord* Rev. Rul. 71-160, 1971-1 C.B. 75. *Cf.* Rev. Rul. 55-609, 1955-2 C.B. 34, where the authorizing statute characterized a payment as a gift.

[120] 1964-2 C.B. 58.

[121] 1953-2 C.B. 112.

[122] 1964-2 C.B. 58-59.

[123] See also Christian v. United States, 201 F. Supp. 155 (E.D. La. 1962), where the taxpayer received an exempt scholarship and an exempt gift from a friend to defray her otherwise deductible travel expense, and the court denied the deduction under § 265(1) because, in a strange twist, the taxpayer admitted that the expense was "allocable to" the gift and fellowship award.

[124] 319 U.S. 98 (1943).

[125] The payments were thought to be tax exempt under Edwards v. Cuba R.R., 265 U.S. 28 (1925).

[126] *Accord* United States v. Chicago, B. & Q.R.R., 412 U.S. 401 (1973); Wolfers v. Commissioner, 69 T.C. 975 (1978).

for stock and the nonrecognition rule of section 351 does not apply to the shareholder, the corporation takes a basis equal to the fair market value of the property.[127] The corporation recognizes no income or gain on the receipt of property from shareholders, whether the property is received in exchange for stock or as a capital contribution.[128] Thus, when property is received from shareholders, a corporation has an exclusion and also acquires a basis to support future deductions.

Farid-Es-Sultaneh

Suppose a husband discharges his wife's debt to her doctor for medical services. The wife has received a payment for support, which is excludable to her,[129] and she also has a medical deduction because she acquires a full basis in the support payment. The basis issue was litigated in *Farid-Es-Sultaneh v. Commissioner.*[130] There, stock acquired in exchange for a release of support and dower rights[131] was held to have been acquired by purchase and to have taken a basis equal to its fair market value when acquired. If Farid-Es-Sultaneh had immediately used this stock to pay her medical bills, she would have had a medical deduction, subject to the usual limitations, and would have realized no gain. Thus, we have the phenomenon of exclusion and deduction for the same item. The deduction is not an event inconsistent with the exclusion because such is the intent of existing law.[132]

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[127] Reg. § 1.1032-1(d). *See* Moore-McCormack Lines, Inc. v. Commissioner, 44 T.C. 745, 762 (1965), *appeal dismissed pursuant to stipulation* (2d Cir. July 19, 1967) (cost of assets is fair market value of stock issued to acquire assets). *See also* Rev. Rul. 62-217, 1962-2 C.B. 59 (corporation distributing shares of treasury stock having a value above basis as compensation to employees for services rendered has a deductible business expense equal to the fair market value of the stock despite the nonrecognition of gain provisions of § 1032(a)). Compare International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943) (shares of taxpayer's corporate shareholder used to pay compensation; fair market value deduction allowable, but appreciation in stock taxable as gain). *Accord* United States v. General Shoe Corp., 282 F.2d 9 (6th Cir. 1960), *cert. denied*, 365 U.S. 843 (1961); Tasty Baking Co. v. United States, 393 F.2d 992 (Ct. Cl. 1968).

[128] I.R.C. §§ 118(a) (contributions to capital), 1032(a) (receipt of property in exchange for stock).

[129] Gould v. Gould, 245 U.S. 151 (1917) (alimony not gross income); Smith v. Commissioner, 40 B.T.A. 1038 (1939) (dictum); Rev. Rul. 55-457, 1955-2 C.B. 527.

[130] 160 F.2d 812 (2d Cir. 1947).

[131] Amounts received for dower rights are also not income. Rev. Rul. 67-221, 1967-2 C.B. 63. *See also* United States v. Davis, 370 U.S. 65, 73 n.7 (1962).

[132] Compare § 422 of the Tax Reform Act of 1984, which adds a new § 1041 to the Code making nontaxable a transfer of property between spouses or incident to divorce and giving the transferee a carryover rather than cost basis.

A similar result should occur when a husband is required by a divorce decree to pay his divorced wife's legal fees. The husband is not entitled to a deduction for the payment: Section 215 (the deduction for alimony) does not apply because the payment is a noncontingent, one time payment that fails the requirement of periodicity, nor is it within section 212(3).[133] But, the question has not been resolved by the courts as to whether *she* can deduct it, for example, under section 212(3). Since the direct payment by the husband to the lawyer is economically the same as a payment to his wife, who in turn pays her lawyer, the wife should have the deduction. The wife's receipt of the payment (directly or indirectly) is not gross income to her because it is nonperiodic support and outside of section 71, but this exclusion should not prevent the deduction since the intended effect of sections 71 and 212(3) is to give her an exclusion for her nonperiodic support[134] and a deduction for a lawyer's tax advice. To deny the deduction because of the exclusion would be an implicit overruling of *Farid-Es-Sultaneh.* Neither should the results be affected by the fact that the funds constructively received by her are earmarked for support.[135]

Statutory Provisions

As already noted in the discussion of deduction-exclusion issues, when Congress wants deferral instead of exclusion, it knows how to say so through basis provisions preventing full value basis. This holds true in the exclusion-deduction area also. Section 109, for example, excludes

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[133] United States v. Davis, 370 U.S. 65, 74–75 (1962) (deduction for tax advice claimed by husband under § 212(3) disallowed since the deducted amount was a payment of a fee incurred by wife for tax advice to her); Rose v. Commissioner, 30 T.C.M. (CCH) 644 (1971) (essentially same facts; no § 215 deduction because not periodic). *Accord* Curley v. Commissioner, 35 T.C.M. (CCH) 1798 (1974); Johnson v. Commissioner, 30 T.C.M. (CCH) 580 (1971).

[134] Barnett v. Commissioner, 33 T.C.M. (CCH) 25 (1974) (payments of attorneys fees are support payments), *rev'd on other grounds,* 75–2 U.S.T.C. ¶ 9513 (10th Cir. 1975).

[135] Section 71 was significantly revised in 1984, but this result was not changed. Hillsboro Nat'l Bank v. Commissioner, 103 S. Ct. 1134, 1148 n.28 (1983), refers to another exclusion-deduction situation. Assume a corporation pays a state tax owed by a shareholder. If the corporation has ample earnings and profits, the payment is a constructive dividend, and, in the absence of a statutory exclusion, the shareholder has gross income equal to the corporate payment on his behalf. If the tax would have been deductible had the shareholder paid it directly, the Court says, he should be allowed a deduction for the corporation's payment of it. In this case, the shareholder has gross income and deduction in offsetting amounts. Section 116, however, provides a limited exclusion of dividends from gross income (presently $200). If the constructive dividend in the example is within the exclusion, the Court implies, the shareholder has both an exclusion and a deduction for the same item.

from a lessor's gross income the value of permanent improvements made by a lessee if the improvements are made for the lessee's own use and not as rent in kind. Section 1019, however, gives the lessor a zero basis for the improvements. The lessor thus cannot depreciate the improvements, and any amount received for the improvements on a sale of the property is gain. Therefore, the exclusion operates as a deferral.[136] When no such basis provision is present, especially for cash receipts, exclusion-deduction is the logical outcome.[137]

No Double Exclusion

We have used *United States v. Kirby Lumber Co.*[138] to show that a borrower cannot exclude both the borrowing and a later discharge of the debt.[139] It is possible, nevertheless, to have double exclusions under *Commissioner v. American Dental Co.*[140] where the principal amount of a debt (rather than expensed interest) is discharged by gift.[141] We submit that *Kirby Lumber* is properly viewed as an application of the tax benefit principle.[142] A second exclusion (exclusion of the discharge) would be inconsistent with the first exclusion (exclusion of the borrowing) because the first was given on condition the debt be paid.

Under this view, it is arguable that a nongratuitous debt discharge can be excluded under the exclusionary branch of the tax benefit rule if exclusion of the earlier borrowing did not give tax benefit. Suppose a taxpayer borrows $100 in a year when a $100 net operating loss carryover is about to expire, but he has enough deductions without the carryover to give him zero taxable income. The exclusion of the borrowing gives him no tax benefit because if the borrowing were included, the

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136 Another illustration is the combination of § 108(a), which excludes from gross income certain income from discharge from indebtedness, and § 108(b)(2)(D), (b)(5), and (c)(1)(A), which sometimes require the excluded amounts to be applied in reduction of the taxpayer's basis for his property. *See also* I.R.C. § 1017.

137 For example, §§ 102/1014, 103, 104 (with an exception for prior medical deductions), 105, 106, and 112–132 (excluding §§ 126 and 127 because of § 126(d) and (e) and § 127(c)(7) preventing both exclusion and deduction).

138 284 U.S. 1 (1931).

139 Recognition of the income on discharge is sometimes deferred by §§ 108 and 1017. *See supra* note 136.

140 318 U.S. 322 (1943).

141 *Supra* note 91.

142 *See* Commissioner v. Tufts, 103 S. Ct. 1826, 1832 n.8 (1983). *Contra* BITTKER, *supra* note 63, at ¶ 6.4.6 (arguing that a *Kirby Lumber* inclusion of debt discharge does not depend on a prior tax benefit); Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129, 144 n.61 (1943) (arguing that the tax benefit rule is inapplicable to *Kirby Lumber* because of the absence of a prior deduction). *See also* Rev. Rul. 70–406, 1970–2 C.B. 16 (applying the § 111 recovery exclusion to a discharge of accrued interest); Rev. Rul. 67–200, 1967–1 C.B. 15.

carryover would prevent any of it from being taxable income.[143] Thus, a later discharge, even if not gratuitous, is arguably within the recovery exclusion allowed by section 111 and the regulations thereunder.

A last example involves section 121. If a home is acquired in an excludable manner, by gift, for example, a sale fitting the gain forgiveness provisions of section 121 (sale by one age 55 or over of property used for the prescribed period as the taxpayer's principal residence) results in a second exclusion.

Part III

Role of Section 265(1)

In *Manocchio v. Commissioner*,[144] section 265(1) was construed by the Tax Court to deny a deduction, otherwise allowable, because the *source* of the claimed deduction was excluded from gross income. The taxpayer, a veteran reporting on the cash method, had been reimbursed for educational costs which he paid during the same year for a flight training program. The Commissioner agreed that these educational costs would ordinarily have been deductible under section 162. Nevertheless, he denied them because the veteran's grant, by the statute under which the grant was made, was "exempt from taxation."[145] Thus, argued the Commissioner, the deduction was "allocable" to a class "of income wholly exempt" and could not be deducted under section 265(1).

The taxpayer, relying on the legislative history of section 265(1), contended that it applied only to deductions related to "the production"

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[143] If the carryover was not about to expire, the borrowing exclusion presumably would give tax benefit since it preserves the carryover for future years, although the analysis is a bit muddy if the carryover persists into the year of the discharge. Section 1.111-1(b)(2) of the regulations defines the recovery exclusion as "the portion of the . . . deductions . . . which could be disallowed without causing an increase in any tax of the taxpayer" and says that "consideration must be given to the effect of net operating loss carryovers and carrybacks." Section 111(d) says that a deduction which causes "an increase in a carryover which has not expired shall be treated as a reduction in tax," that is, as a deduction which could not be disallowed in any part without increasing tax. In our example, the exclusion prevents a decrease in a carryover. If the carryover is a carryover to the year of the discharge, it should be deemed to have reduced tax for purposes of § 111(d). *See* S. Rep. No. 1035, 96th Cong., 2d Sess. 20 (1980). This report clears up the ambiguity in the statute as to the meaning of "not expired." The deduction must increase a carryover that had not expired at the end of the taxable year when the recovery occurs. In our example, the carryover expires prior to the recovery year, and so the exclusion does not cause a reduction in tax. Obviously, a recovery in the next year could not be offset by the lapsed carryover.

[144] 78 T.C. 989 (1982), *aff'd on other grounds*, 710 F.2d 1400 (9th Cir. 1983). The same approach is taken by the Commissioner in Revenue Ruling 83-3, 1983-1 C.B. 72.

[145] 38 U.S.C. § 3101 (1982).

of tax-exempt income and that the tax exempt nature of the *source* of the deduction was irrelevant. The Tax Court rejected the taxpayer's contention stating:

> We agree with the petitioner that if the income derived from his employment as a commercial pilot were tax-exempt, and his educational expenses were *not* reimbursed by the VA, the flight-training deduction would be allocable to such income for purposes of section 265(1). We do not agree, however, that the deduction is permanently locked into his employment income where the expenses are also subject to exempt reimbursement. In that situation, we think the proximate one-for-one relationship between the reimbursement and the deduction overrides the underlying relationship between the deduction and the employment income, leaving the deduction "directly allocable," as that term is used in section 1.265-1(c), Income Tax Regs., solely to the reimbursement and to no other class of income.[146]

In a concurring opinion, Judge Fay attempted to soften the majority's approach, refusing to read it as denying a deduction where the source of the payment was tax exempt:

> I agree petitioner's claimed deduction is disallowed by section 265(1). However, I disagree with any implication that we are deciding section 265(1) applies to expenses paid out of exempt income as well as to expenses incurred in the production of exempt income.
>
> In a reimbursement situation such as the one presented herein, the expense may be said to have produced the exempt income simply because, if the expense had not been incurred, there would not have been any exempt income.[147]

Whatever the merits of the distinction drawn by Judge Fay, the simplest and, in our opinion, most accurate reaction to *Manocchio* is that it broadens section 265(1) beyond its purpose. Fairly read, especially in light of its legislative history,[148] section 265(1) is unconcerned with the *source* of the payment claimed as a deduction. To be sure, the crucial word of section 265(1)—"allocable"—admits of both a source and production purpose, but it seems clear that this is not what Congress had in mind.

In support of this proposition, one could point to the companion provision of section 265(2), which prohibits a deduction for interest on loans made or continued to purchase tax exempt bonds. Without question, this provision speaks only to the question of the *production* of tax exempt income.

[146] 78 T.C. at 995.
[147] *Id.* at 1003.
[148] *Id.* at 993 n.4.

One could also point to the haphazard manner in which the Tax Court's analysis operates. Suppose taxpayer *A*'s parent gives him cash with no strings attached and *A* thereafter uses the money to pay for otherwise deductible education, whereas taxpayer *B*'s parent reimburses her for the costs of a particular educational course. Can we attribute to Congress an intent to allow *A* a deduction, but disallow the deduction to the *B*? The Tax Court's earmarking approach in *Manocchio* would draw this distinction.

In the final analysis, however, the main objection to the Tax Court's approach to section 265(1) is that it precludes analysis of, by assuming the answer to, the question whether Congress intended to preclude any deduction for an expense paid with funds received tax free. The unanalyzed assumption of both the Commissioner and the Tax Court in *Manocchio* is that Congress intended that section 265(1) always bar this double benefit.

Actually, section 265(1) can be seen to emanate from a different objective: to disallow deductions of the costs of producing tax-exempt income so that such costs are allocated only to exempt rather than taxable income. This objective is completely consistent with allowing a double benefit when tax exempt income is used to pay a deductible expense. Suppose *T* receives $10 in salary and $10 in interest exempted by section 103, and pays a $10 investment fee directly related to the interest. If the interest were includable in gross income, *T*'s taxable income would be $10, an amount equal to his salary, because he has no net income from interest. The exemption of the interest is not intended to allow *T* to pay less tax than he would have if he had had no interest income at all. Without section 265(1), however, *T*'s taxable income would be zero because the investment expense, incurred solely to produce the interest, would be deducted from the salary. Section 265(1) is thus needed to bar deduction of the expenses of earning tax-exempt income so that the exclusion of the income does no more than exempt it alone from tax. In effect, section 265(1), as noted above, requires matching tax-exempt receipts with the cost of producing them. Without section 265(1), section 103 would, in effect, cause a second $10 exclusion through a deduction of the costs against taxable income. Thus, section 265(1), as applied to expenses in producing tax-exempt income, is not a retreat from the congressional policies exempting the income. In the example, (1) the cost of earning tax-exempt income is not permitted to be deducted against taxable income, and (2) the section 103 exclusion is in no way thwarted. This is so because, even without section 103, there would only be $10 of salary income, both economically and from a tax position.

Assume, in contrast, that *T* has $10 of salary income, pays $10 for educational expenses that maintain skills used in his employment, and receives reimbursement of this expense from the government under a statute specifying that the reimbursement is tax exempt. If *T* had not received the reimbursement, his taxable income would have been zero. With the reimbursement, the result is the same if the reimbursement does not bar the deduction. If the reimbursement makes the expense nondeductible, however, taxable income is $10. Allowance of the deduction does not reduce taxable income to less than what it would have been if no tax exempt income had been received. Denial of the deduction, on the other hand, makes taxable income greater than it would have been in the absence of the tax-exempt reimbursement, and thus improperly takes away the benefit of the tax exemption.

Another example may help to clarify this analysis. Suppose *T* earns $10 of salary and pays it to a lawyer in order to obtain $10 of exempt tuition assistance under a program for veterans. He then uses the $10 of the benefits to pay tuition ordinarily deductible under section 162. When he completes the education, his employer pays him a bonus of $10 in recognition of his increased ability and earning capacity.

The lawyer's fee paid with the salary is clearly not deductible because under section 265(1) it is the *cost of producing* tax exempt veteran's benefits. After payment of this fee, *T* has no net economic gain from the $10 of exempt benefits. The use of the exempt benefits to pay tuition, however, would also cause the Tax Court in *Manocchio* to disallow tuition expense as a deduction because the exempt bénefits are the *source* of the otherwise deductible payment. The net effect of this construction of section 265(1) is to produce $20 of taxable income, even though there is only $10 of economic gain.[149] The reason for this is the use of both the cost of production rule and the source rule to allow one exempt item of $10 to deny two deductions totalling $20.

Of course, in many cases, like *Manocchio*, there is no outlay to produce the tax-exempt benefit; that is, no outlay such as the attorney's fee in our last hypothetical. The result of the *Manocchio* construction in these cases is not to deny two claimed deductions because of one exclusion (since only one deduction is being claimed), but rather to deny the exclusion of the veteran's benefit by denying the educational expense deduction under section 265(1). If, for example, we removed the $10 of salary and the $10 attorney's fee in our last hypothetical, *Manocchio* would still result in $10 of taxable income. While it is true that there is

[149] That is, $10 salary, plus $10 veteran's benefits, plus $10 bonus, minus $10 attorney's fee, minus $10 tuition payment. The bonus is part of the illustration to highlight the fact that the educational expense is really a cost of producing taxable income. The same analysis would apply absent the bonus since then the benefit becomes the cost of future taxable income to be earned by the education obtained.

a bonus of $10, that bonus does not represent any economic gain because there was $10 of cost (the tuition payment) required to produce it. The effect of *Manocchio* is to tax the veteran's benefit and therefore deny the exclusion.

In summary, the Tax Court's approach to section 265(1) in *Manocchio* is unsupported by legislative history, and is haphazard in its operation. In some situations, it causes taxable income to exceed economic gain. In other situations, without any real analysis of the issue, congressional exclusionary policies are rendered subservient to the policy of accurately reflecting economic gain, an approach which is, at bottom, antithetical to the Supreme Court's enlightened approach to the tax benefit rule in *Hillsboro*.

Conclusion

The above analysis of section 265(1) demonstrates that the source rule is improper, and section 265(1) should not clutter the analysis of either a *Manocchio* type case or, for that matter, any case where tax-exempt income is in the picture. The critical, and proper, analysis should proceed under the tax benefit rule and the inconsistent treatment analysis outlined in Parts I and II.